

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0120
Corporate Income Tax
Tax Period: 2002 - 2004

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ISSUES

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense

Authority: IC § 6-3-2-2(l); 45 IAC 3.1-1-62.

Taxpayer protests the disallowance of deductions for business expenses related to royalty payments made to an affiliated company.

III. Tax Administration – Ten Percent Negligence Penalty

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state entity in the business of selling clothing at retail. The retail operation is a nationwide enterprise, with several of its retail stores located in Indiana. Taxpayer purchases the merchandise that it sells at retail from an affiliated company ("Affiliate B"), also an out-of-state entity. Included in the purchase price of the clothing (all clothing and merchandise bear the brand name of the related entities) is a royalty fee, which amounted to 28 percent of the cost of the merchandise in 2002, and 26 percent in the two subsequent years. Affiliate B then pays the royalty fee to another affiliated company ("Affiliate A"), a Delaware holding company, pursuant to a licensing arrangement for the Affiliate B's use intellectual property.

Affiliate A is responsible for developing and controlling all intellectual property of the affiliated companies. This includes the graphics, icons, and other images printed on (or otherwise attached to) the merchandise, and also includes the store name and any signs bearing the name in front of, and inside of, the stores. The royalty payments, which have not been taxed by Indiana, Delaware, or any other state, are used to offset the costs of development, as well as to pay for the administrative services provided by an affiliated management company ("Affiliate C") and legal services of outside counsel in protecting the intellectual property. Affiliate A transfers excess

money received to Affiliate C. The royalty payments paid by the taxpayer and other related entities amount are Affiliate A's only source of income.

Taxpayer, the three affiliates, and other related entities are subsidiaries of an out-of-state parent company. Affiliate A has no employees, but instead contracts out its functions with other parties, including some administrative functions to Affiliate C.

The Department conducted an audit of taxpayer's financial records spanning the 2002, 2003, and 2004 tax years. As a result of that audit examination, a number of adjustments were made which served to increase taxpayer's tax liabilities. Taxpayer disagreed with certain of those adjustments and submitted a protest to the Department of Revenue (Department). Pursuant to that protest, an administrative hearing was conducted during which taxpayer was provided an opportunity to substantiate the basis for its protest. As a result of that hearing, this Letter of Findings was prepared.

I. Adjusted Gross Income Tax – Disallowance of Royalty Expense

DISCUSSION

A document entitled "Amended and Restated Intellectual Property Protection Agreement" ("licensing agreement") was signed on February 2, 2001, between Affiliate A, the affiliated Delaware holding company that controls the company's intellectual property, and Affiliate B, the affiliated company in charge of merchandise production and distribution, the agreement became effective retroactive to August 27, 2000. The licensing agreement provided that Affiliate B, as licensee, was granted "a non-exclusive right, permission and privilege to use the Intellectual Property worldwide in connection with the operation of [Affiliate B's] business" by Affiliate A, as licensor. The licensing fee ("royalty rate") that Affiliate B had to pay to Affiliate A was 28 percent of Affiliate B's net sales of merchandise sold that was imprinted with or otherwise containing any of Affiliate A's intellectual property. The royalty rate was later amended to 26 percent pursuant to a vote taken by a quorum of the Board of Directors of Affiliate A in December of 2002.

Taxpayer purchased clothing and other merchandise from Affiliate B. When Affiliate B received the payment, it would transfer 28 percent (later 26 percent) of the sum to Affiliate A. Later, when calculating its adjusted gross income derived from sales made within the state, taxpayer would claim those royalty payments as deductible business expenses. The audit determined that "the level of intercompany royalties significantly distorts taxpayer's Indiana income," and consequently disallowed this deduction.

Taxpayer filed a protest with the Department regarding the disallowance of royalty payments. The audit disallowed the 2002-2004 royalty payments pursuant to IC 6-3-2-2(l), which states as follows:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana,

the taxpayer may petition for *or the department may require, in respect to all or any part of the taxpayer's business activity*, if reasonable:

- (1) separate accounting;
- (2) the exclusion of any one (1) or more of the factors;
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) *the employment of any other methods to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added).*

This provision is bolstered by 45 IAC 3.1-1-62, which states in part that:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) . . . unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing *or the Department may require the use of a more equitable formula for determining Indiana income.*

During the hearing, taxpayer conceded that there was no legal basis for their protest. Therefore, the Department respectfully denies taxpayer's protest.

FINDING

The taxpayer's protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty

DISCUSSION

The taxpayer protests the imposition of the ten percent negligence penalty pursuant to IC 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2 (b) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall

be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The taxpayer established that its failure to pay the assessed tax was due to reasonable cause rather than negligence.

FINDING

The taxpayer's protest to the imposition of penalty is sustained.